Nos. 645, 646

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JAMES Q. NEWTON TRUST

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ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (No. 645, R. 12–18; No. 646, R. 22–29) is reported in 42 B. T. A. 473. The opinion of the Circuit Court of Appeals (No. 645, R. 44; No. 646, R. 47–48) is reported in 122 F. (2d) 416.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered July 24, 1941. (No. 645, R. 44–45; No. 646, R. 48). The petition for writs of certiorari was filed on September 23, 1941. Following denial on February 9, 1942, a petition for rehearing was filed on February 28, 1942, and the petition was granted on March 9, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to a Section 77B plan, corporate assets were transferred to a new company, new bonds and stock distributed to former bondholders, and the stock interests eliminated except for the receipt of stock purchase warrants. The question is whether gain should be recognized upon the taxpayer's exchange of bonds for new bonds and stock. The answer depends upon (1) whether the exchange was tax-free under Section 112 (b) (3) of the Revenue Act of 1936, which in turn depends upon the question of whether the plan constituted a "reorganization" within the definition of Section 112 (g) (1); or (2) whether the exchange constituted a tax-free transfer under Section 112 (b) (5).

STATUTES AND REGULATIONS INVOLVED

The provisions of the statutes and regulations principally involved are set forth in the Appendix to the Government's brief in *Helvering* v. *Cement Investors, Inc.*, No. 644. Additional provisions in-

volved herein are set forth in the Appendix, *infra*, pp. 10–12.

STATEMENT

These cases involve precisely the same facts, except for the different taxpayers and amounts involved, and the same ultimate issue as *Helvering* v. *Cement Investors, Inc.*, No. 644. The facts have been stated, and the Government's position with respect to the principal questions involved has been developed, in its brief filed in the *Cement Investors* case. The Court is respectfully referred to that brief.

The taxpayers in the instant cases, however, have advanced the further argument that the transaction constituted a "statutory merger or consolidation" within the meaning of Clause A of the reorganization definition of Section 112 (g) (1) of the statute. The Board of Tax Appeals rejected this contention, and the court below did not pass upon it. The point has not been discussed in our brief in the *Cement Investors* case, since that taxpayer expressly stated in its brief below its agreement with the Commissioner that Clause A did not apply. We are considering the contention here against the possibility that it may again be pressed in the instant cases.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayers' securities had been exchanged pursuant to a plan of "reorganiza-

tion," and that therefore gain would not be recognized.

(2) In holding that Section 112 (b) (5) precluded recognition of gain upon the exchange of the taxpayers' securities.

(3) In failing to hold that the gain realized upon the exchange of the taxpayers' securities should be recognized under Section 112 (a).

(4) In sustaining the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

Section 77B itself is not a merger or consolidation statute within the meaning of Clause A of Section 112 (g) (1) as interpreted by the treasury regulations. The applicable corporation statute here was the law of Colorado. The procedure required to effect a consolidation under that statute was not employed in effecting this plan. While Section 77B provides that a merger or consolidation may be employed as a means of effecting a plan, the record shows no reference to the use of such machinery.

ARGUMENT

THE TRANSACTION DID NOT CONSTITUTE A "STATUTORY MERGER OR CONSOLIDATION" WITHIN THE MEANING OF CLAUSE A OF SECTION 112 (g) (1) OF THE REVENUE ACT OF 1936

1. Beginning with the Revenue Act of 1934, Clause A of the reorganization definition was

amended to apply only to "a *statutory* merger or consolidation." (Italics supplied.) Prior thereto, the clause had included within the definition "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)":[1] Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 112 (i). In the light of the amendment, Clause A has now been interpreted by the Treasury Regulations to "refer to a merger or consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia." Treasury Regulations 94 (Revenue Act of 1936), Article 112 (g)–2. See also Treasury Regulations 103 (Internal Revenue Code), Article 112 (g)–2; Treasury Regulations 86 (Revenue Act of 1934), Article 112 (g)–2, as amended by T. D. 4585, XIV–2 Cum. Bull. 54 (1935).

Section 77B itself is plainly not such a law.[2] While it requires that a plan provide adequate means for its execution which may include a merger

[1] In the 1934 and subsequent acts, the parenthetical phrase was retained in modified form as Clause B. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 10 (1939–1 Cum. Bull. (Part 2) 586, 598).

[2] Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as added by Act of June 7, 1934, c. 424, 48 Stat. 911, Sec. 77B (U. S. C., Title 11, Sec. 207).

or consolidation (Section 77B (b) (9)), it recognizes that the corporate power and authority to effect such a transaction is derived from the law which creates the corporation. The power to merge or consolidate must be found in that law. Section 77B confers jurisdiction upon the federal courts to sanction plans which direct the execution of various corporate steps in order to effect the reorganization, but the statute does not itself confer the necessary corporate powers or otherwise purport to give corporate transactions operative effect.[5] This is accomplished by the applicable corporation statute.[6]

2. The applicable corporation statute here was the law of Colorado, under which both the old companies and the new were incorporated. This statute contains specific provisions authorizing consolidations (Colorado Statutes, Ann. (1935), Vol. 2, c. 41, Sec. 54 (Appendix, *infra*)), but it is obvious that they were not employed in effecting the plan.

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[5] A ready example of a federal corporation law containing consolidation provisions is the national bank laws. They provide for the consolidation of national banking associations formed under, and deriving their corporate powers from, federal law. Revised Statutes, Sec. 5133 (U. S. C., Title 12, Sec. 21); Revised Statutes, Sec. 5136, as amended (U. S. C., Title 12, Sec. 24); Act of November 7, 1918, c. 209, 40 Stat. 1043, as amended, Secs. 1, 2, 3 (U. S. C., Title 12, Secs. 33, 34, 34 (a)).

[6] These same comments also apply to the revision of Section 77B adopted in 1938 as Chapter X of the Act of June 22, 1938, c. 575, 52 Stat. 840, 883.

In order to have a consolidation under Colorado law, it is necessary to call a meeting of stockholders to vote upon the consolidation and to obtain the approval of three-quarters. A certificate of incorporation is then prepared, signed and acknowledged by at least three of the stockholders of each of the consolidating companies, which, *inter alia,* sets forth the facts of the consolidation and names the new directors. The properties of the consolidating companies are then transferred to the new company, and when this has been done, the directors of the consolidated company call in the stock of the consolidating companies, cancel it, and issue the new. Colorado Statutes, Ann., *supra.* These were not the steps taken in the instant case, as we shall show below.

Indeed, it is difficult to see how it would have been possible for the Colorado consolidation statute to be applied here. That statute contains no provisions permitting the elimination of stock interests or for the satisfaction or alteration of creditors' claims. On the contrary, it provides expressly that the new company shall "be responsible for and shall assume and pay all the just liabilities of each of the companies so consolidated". *Ibid.* These provisions necessarily conflict with the pattern and purposes of an insolvency reorganization under the Bankruptcy Act. They are patently inconsistent with what was done here.

3. Section 77B, as we have indicated, provides a number of means which may be employed in the

execution of the plan, of which a merger or consolidation is but one. These means also include "the transfer of all or any part of the property of the debtor to another corporation * * * the satisfaction or modification of liens, indentures, or other similar instruments," and "the issuance of securities of either the debtor or any such corporation or corporations * * * in exchange for existing securities, or in satisfaction of claims or rights, or for other appropriate purposes." Section 77B (b) (9), *supra*.

These were the means employed here. The plan provided for the creation of a new corporation, which would acquire the assets of the old companies. Following confirmation of the plan, the court on June 20, 1936, entered an "Order Approving the Form of Documents and Directing the Transfer of Assets to, and the Issue of Securities and Assumption of Liabilities by, the New Company." (No. 644, R. 131–142.) The order directed the debtors, the reorganization trustee, and the indenture trustee for the Industrial bonds, to transfer all their interests in the assets of the enterprise to the new company (No. 644, R. 133) and directed the latter to issue the new securities to the order of the reorganization managers (No. 644, R. 134). The indenture trustee was further directed thereupon to execute and deliver to the new company a proper instrument satisfying and discharging the Industrial mortgage (No. 644, R. 135–136); the reor-

ganization managers were directed to distribute the new securities (No. 644, R. 139); and all creditors and stockholders were perpetually enjoined from prosecuting any claims against the new company (No. 644, R. 141). These steps were carried out. The new securities were issued to the reorganization managers as consideration for the assets, and distributed according to the plan. In the final decree all debts, liabilities of, and stock interests in, the old company were discharged, and any attempt to enforce them permanently enjoined (No. 644, R. 190–191).

Nowhere in the plan, or in any of the relevant instruments, is there any reference to a merger or consolidation. None was in fact involved.

CONCLUSION

The judgment of the court below should be reversed.

Respectfully submitted,

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APRIL 1942.

APPENDIX

Colorado Statutes, Ann. (1935), Vol. 2, c. 41:

§ 54. *Consolidation—How consummated—Not to affect debts.*—Any corporations, existing for any of the purposes enumerated in this chapter, may consolidate by uniting the properties and concerns of two or more corporations in one organization, having all the rights and privileges of this chapter, and amenable to all its liabilities, by complying with all the requirements herein provided, to-wit: Each corporation desiring to consolidate, each with the other, may, by its trustees or directors, or by the stockholders representing a majority of the stock, call a meeting of the stockholders, as provided in section 131 of this chapter, and vote upon the proposition of consolidation that shall be presented in writing, at such meeting, when if by a vote of at least three-fourths of the stock of each company severally, the proposition shall be approved, the trustees or directors shall thereupon elect their proportion of the directors, less one, that are to manage the affairs of the consolidated company, and upon the joint meeting of the directors so elected, the said directors shall elect one of the stockholders to be a director and act with them, and they jointly shall constitute a board of directors, who shall organize by electing their officers in accordance with law. They shall prepare a certificate of incorporation setting forth the facts of consolidation, together with all other matters required in original certificates of incorporation, naming therein the directors elected as herein provided, who shall serve for one year and until their successors are elected; and the said certificate of incorporation shall be signed and acknowledged by at

least three of the stockholders of each of the consolidating companies. The certificate so signed and acknowledged shall be filed for record in the office of the secretary of state, and in each of the offices of the county recorders where the certificate of either of the companies so consolidated are on file. The trustees or directors of the consolidating companies shall, each by proper conveyance, convey to the consolidated company the property and effects of such companies, and shall deposit with the directors of the consolidated company all the transfer books, seals, books and papers of each of the companies so uniting. The directors of the consolidated corporation shall call in all the stock of each of the companies forming a part of the consolidation, cancel the same, and issue in lieu thereof the stock of the new organization in proportion of value of the old to the new, as provided in the plan of consolidation; provided, no stock shall be issued in lieu of old stock except upon presentation of the old stock or due proof of the loss or destruction of the old certificates of stock, and then only to the parties entitled thereto. When the companies have consolidated as herein provided, the stock of the companies so consolidated shall thereafter represent only its interest in the new organization, whether surrendered and exchanged or not, and shall be subject to all the liabilities of assessment and forfeiture that may pertain to the stock of the consolidated company, and the consolidated company shall be responsible for and shall assume and pay all the just liabilities of each of the companies so consolidated; and any corporation desiring to change its name, place of business, number of directors or trustees, or amount of capital stock; shall submit the question at an annual meeting, or a special meeting called for that purpose, in accordance with the

provisions of section 131 of this chapter. If, at any such meeting, three-fourths of all the stock of such corporation shall vote in favor of the proposed change, or changes, a certificate setting forth the fact, or facts, verified by the affidavit of the president of said corporation, and having the seal of the corporation affixed, shall be filed for record with the secretary of state and the recorder of the county where the principal business office of said corporation is located.

§ 55. *Publication of notice of consolidation.*—Such corporations shall, upon the filing of said certificates, cause to be published in some newspaper, in or nearest the county in which their principal office is located, a notice of such changes of organization, for three successive weeks.

§ 56. *Not to affect pending suits.*—Such change of name, place of business, increase or decrease of capital stock, increase or decrease of number of directors, managers or trustees, or consolidation of one corporation with another or with others, shall not affect suits pending in which such corporation or corporations shall be parties; nor shall such change affect causes of action, nor the rights of persons in any particular; nor shall suits brought against such corporation by its former name be abated.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 112 (g)-2. *Definition of terms.*—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). * * *

The words "statutory merger or consolidation" refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia.

U. S. GOVERNMENT PRINTING OFFICE: 1948